

STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 99-851

DECEMBER 27, 1999

MAINE PUBLIC UTILITIES COMMISSION
Investigation into Bell Atlantic
Maine's Alternate Form of
Regulation

NOTICE OF INVESTIGATION

WELCH, Chairman; NUGENT and DIAMOND, Commissioners

I. INTRODUCTION

In accordance with the provisions of 35-A M.R.S.A. § 1302 (3), we issue this Notice of Investigation (NOI) to initiate the process of determining whether we should continue, modify or terminate the Alternative Form of Regulation (AFOR) that was implemented for Bell Atlantic – Maine (Bell, B/A-ME or the Company) by an Order issued in Docket No. 94-123 on May 15, 1995 (AFOR Order). If we decide to modify or terminate the AFOR, we must then determine what regulatory mechanism will take its place for B/A-ME.

We begin this investigation by soliciting comments from interested persons regarding the issues that we should address and the process that we should follow to resolve this matter as expeditiously as possible. The current AFOR will end on December 1, 2000. In this NOI, we briefly describe the current AFOR, review its background, and delineate the issues to be addressed in this proceeding, as we have initially identified them. Finally, we describe our proposal for processing and scheduling this case. Interested persons are asked to review and provide comments on the proposed issues, process and schedule.

II. THE CURRENT AFOR

The Commission adopted the current AFOR for B/A-ME (then known as NYNEX) for effect on December 1, 1995, under the authority granted in 35-A M.R.S.A. § 9103. The Commission determined that the AFOR mechanism met each of the statutory requirements and decided that the initial term of the AFOR would be five years, with a possible extension of as much as five years. The Commission stated that it would review the AFOR prior to the end of its initial term to decide whether to continue the plan for an additional five years, modify it or abandon it. The Commission based the initial term on several factors. First, the Bell AFOR was the first plan implemented under section 9103 and, as such, it was somewhat experimental in nature. Second, the Commission indicated that the most difficult evidentiary task it faced was that of establishing the productivity offset that is used in the Price Regulation Index (PRI), and it expressed uncertainty whether the 4.5% chosen for the initial term would be

appropriate beyond five years. Finally, because of the rapidly changing nature of the telecommunications industry, the Commission found it was both prudent and necessary to assess the competitive and regulatory environment that existed at the end of the initial term of the AFOR.

The present AFOR contains a price cap mechanism and pricing rules for Bell's core services. Core services are divided into discretionary and non-discretionary categories, with different rules for each category. Non-core services are not covered under the price cap, but their pricing is subject to a floor based on long-run marginal cost. The mechanism for determining the allowed level of prices is the PRI, which quantifies the effect of inflation, as measured by the Gross Domestic Product Price Index ("GDPPI"), on the Company's costs, reduced by a Productivity Offset of 4.5%. In addition, the effects of a limited number of defined exogenous events may be included in the calculation. The PRI is the target level for the allowed or required annual changes to the Company's average prices. The actual price changes made by the Company are accounted for through the Actual Price Index (API), which is a weighted average of B/A's core service prices calculated using the Company's implemented or proposed price changes and the billing units from the current AFOR year. Price reductions that occur during an AFOR annual period, i.e. at a time other than December 1st of each year, are included in the API calculation for the following AFOR period. The basic requirement is that the API must be less than or equal to the PRI at each annual measurement point, but for other than basic exchange service, the Company has discretion to select which prices it will adjust.

Prices for non-discretionary services cannot be increased if the annual change in the PRI is negative, and any increases in the prices of discretionary services must be offset by price decreases sufficient to bring the API down to its required level. The mechanics of the process by which the PRI and the API are adjusted annually to ensure compliance with the AFOR decision are described in an Order issued by the Commission on December 23, 1997, in Docket Numbers 94-123 and 97-079. This process was implemented to ensure year-to-year consistency and avoid controversy at the time of each annual filing.

A. Quality Service

Because the AFOR disconnected the direct link between the Company's costs and its allowed revenue, and allowed the Company to retain all of the efficiency benefits it could produce beyond the productivity factor included in the PRI formula, the Commission was concerned about the effect of alternative regulation on the service quality provided by B/A-ME. The Commission expressed concern that under an AFOR a utility could focus on profit enhancement through cost cutting to such an extent that it would allow its service quality to deteriorate. To provide an incentive for the Company to avoid drop in service quality, the Commission instituted a Service Quality Index (SQI), with monetary penalties of sufficient magnitude to ensure that B/A would continue to devote adequate attention and resources to providing its services at the level of quality that customers had come to expect, as measured by actual experience during the three years prior to the beginning of the AFOR.

The SQI covered three basic areas: customer service (with three indices), service reliability (four indices) and customer satisfaction (four indices). In the Order adopting the AFOR, the Commission recognized 12 indices as being appropriate, but only 11 indices were included in the initial measurement system, because sufficient historic data was unavailable for development of a Maine-specific service outage index. Subsequently, a network outage index was implemented after consultation between the Company and our staff.

In the initial Order, each index was set equal to a dollar penalty amount based on the proportionate level of non-compliance, with the maximum annual penalty capped at \$1 million per SQI index, and \$10 million total for any year. In a Stipulation in Docket No. 94-123 (Reopened), accepted by the Commission in an Order dated March 17, 1998, the penalty for non-compliance with the Network Outage index was increased to a maximum of \$2 million per year and the maximum SQI penalty was increased to \$11 million for any year in which the Network Outage penalty exceeded \$1 million. This increase in the penalty for failure to meet network reliability standards was implemented to recognize the high level of importance the Commission places on having Bell keep its Maine network up and running to meet the needs of its customers.

B. Criteria for Assessment

The Commission adopted the Bell Atlantic AFOR after finding that it complied with each of the requirements set forth in the statute that authorizes an alternative form of regulation. The Commission found that consumers would benefit by the workings of the AFOR in several ways. First, it would be more likely to result in lower prices than traditional rate of return regulation. Next, the AFOR would encourage the deployment of new services desired by customers, with market forces driving their introduction, and increase efficiency by providing appropriate incentives. The plan would also provide incentives for the company to continue to provide customer service at its historic high level. Finally, the AFOR would reduce administrative burdens brought about by regulation.

In the AFOR Order, the Commission delineated the criteria it would use at the conclusion of the initial AFOR term to evaluate the success of the plan. AFOR Order at 35-37. While the Commission did not adopt an earnings sharing component as part of the AFOR, the Commission concluded that examining the Company's earnings at the conclusion of the initial AFOR term would be an important element in the evaluation. The level of the Company's earnings, however, would provide only part of the answer in determining the success of the AFOR. Other criteria found to be relevant include whether universal service has been enhanced, the quality of service has been maintained or improved, prices have fallen, and the company has been able to earn a reasonable return on its investment. See AFOR Order at 37.

In this proceeding, we seek comments regarding the continuing validity of these criteria, and assuming they are still valid, we request input on how well the current

AFOR mechanism has met the goals. In addition, we seek comments regarding any changes to the AFOR plan that would enhance incentives for the Company to meet the plan's objectives.

III. OTHER AFOR RELATED ACTIONS

This section describes several events that occurred after the adoption of the AFOR that may need to be considered in deciding its future.

A. The Bell Atlantic/NYNEX Merger

In its Order approving the merger of NYNEX and Bell Atlantic, the Commission stated that it could not find that ratepayers would be adversely affected by the merger due to a diminution of competition, because Bell Atlantic was not likely to become a direct competitor of NYNEX in Maine, but that customers should realize some of the benefits that were purported to result from the reorganization. *New England Telephone and Telegraph Co. and Nynex Request For Approval of Reorganization Intended to Effect the Merger With Bell Atlantic Corporation*, Docket No. 96-388 (February 6, 1997). The Commission stated that the timing of the net cost savings was somewhat uncertain because of the relatively large up-front costs of the merger, but that ratepayers would be insulated from the implementation costs through the workings of the AFOR. NYNEX could not seek a rate increase to recover the implementation costs during the three years following the merger, but the Commission would be able to examine any actual or purported cost savings that result from the merger at the time of the AFOR review.

The Commission asserted that ratepayers could benefit from the net cost savings in at least three ways. First, because of reduced expenses, NYNEX could be in a better position to respond to competitors, resulting in more and better service offerings at lower prices. Second, at the time of the AFOR review, the Commission could examine any realized cost savings and the Company's level of productivity in general, and it could adjust the AFOR mechanism to account for those factors. Finally, the Commission could impute some level of cost savings, because in approving the merger, it was relying on the existence of those savings to overcome the effects of any possible diminution of competition. The Commission determined that neither a rate reduction nor an increase to the productivity offset was warranted at the time of merger approval. Rather, the merger was an example of the kind of cost-cutting activity that the AFOR was designed to encourage, and to flow through anticipated savings to ratepayers, or to increase the productivity offset at that time, would weaken the incentives built into the AFOR.

The Commission was also concerned about the possible effect of the merger on service quality, because Maine would become a smaller portion of the combined entity, and Bell Atlantic might tend to focus its attention and its investment dollars in other areas. To avoid this possibility, the Commission ordered the Company to invest in telecommunications infrastructure in Maine for the four years following approval of the merger at a rate comparable to that of its average investment in Maine during the years 1992 through 1995. In addition, the Company was required to file a

proposal that would establish benchmarks to permit the Commission to ensure the continued appropriate relationships between services, facilities, infrastructure and prices offered by the Company in Maine and those offered in other jurisdictions of the Bell Atlantic/NYNEX combined service territory. The Commission approved the Company's proposal, and this provision was extended in the access rate stipulation that we describe later in this document. The Company made the required annual filings to demonstrate that the comparability benchmarks were being met in Maine.

B. The Dial Tone Speed Stipulation

In 1997, the Company filed a request for a waiver of one of the performance measurements contained in the SQI included in the AFOR. The Company asserted that increased Internet usage on the switched network was resulting in holding times that vastly exceeded the design criteria of the network. As a result, the Company failed to meet the DTS benchmark for the 1996/1997 service year, and incurred a rebate obligation of \$750,000 for this index. In Docket No. 97-389, the Commission approved a Stipulation that revised upward the baseline for the Dial Tone Speed (DTS) index. The index, which had initially been set at .04% of calls during the busy hour, was increased gradually over the three remaining years of the AFOR to a standard of .36% for the final SQI year. While the percentage increase contained in the Stipulation was significant, it still means that for every 1000 call attempts during the busy hour, no more than 36 would have to wait three or more seconds before receiving dial tone.

The Stipulation also provided a waiver of half of the penalty that B/A-ME incurred because of its failure to meet the DTS benchmark. Instead, the Company agreed to use the waived rebate amount to devise ways to mitigate the deleterious effects that the Company claimed Internet usage was having on the DTS of B/A-ME's switched network. The Company subsequently implemented a program that allowed it to offer incentives for Internet Service Providers (ISPs) to move from a standard line-side connection to a trunk-side serving arrangement. With trunk-side connections, traffic to ISPs does not require use of line termination units at the serving wire center, thus leaving those units available to handle other calls. This program helped move a significant amount of data traffic bound for ISP's off of the switched network, at least on the terminating end of the calls. Since the implementation of this program the Company's DTS measurements have been well below the adjusted standards. In fact, the results generally have been close to, or in some months even below, the original .04% standard. Apparently, even with the continuing growth in Internet usage, the moving of the ISP-bound traffic off of line-side connections, along with the addition of some line units and the rearranging of some customers' lines on the line units, have improved the ability of the switched network to maintain DTS results at its historic levels.

C. Access Rate Reductions

In 1997, Public Law 1997, Chapter 259 became effective and was codified at 35-A M.R.S.A. § 7101-B. This law required that by May 30, 1999, the Commission set the intrastate access rates of local exchange carriers (LECs) at or below the interstate access rates charged by the LECs. In Docket No. 97-319, the Commission ordered an initial reduction of 20% to B/A-ME's intrastate access rates effective July 1, 1997. In

addition, the Commission opened a docket to explore how to achieve the access rate reductions required by the statute.

After a series of negotiating sessions among the interested parties, a Stipulation was reached that the Commission approved. Under the Stipulation, the Company agreed to comply with the statute by reducing its intrastate access rates to the interstate level on May 30, 1999, with an interim decrease occurring on May 30, 1998. To recoup a portion of the lost revenue, the Company was allowed an exemption from the AFOR provision that froze local rates for the term of the AFOR, and B/A-ME could increase its basic local service rates by \$3.50 in a series of three steps over about a year and a half. The Stipulation contained a provision that described the mechanism by which the effects of the rate changes would be included in the Company's API calculation.

The Stipulation also contained a provision allowing the Company to enter into special contracts without prior approval of the Commission, provided that the price floor constraints were met. As noted above, the maximum penalty under the network outage index of the SQI was increased from \$1 million to \$2 million per year, and in any year in which the network outage penalty exceeds \$1 million, the overall maximum SQI penalty was increased to \$11 million.

Finally, another provision in the access rate Stipulation rescinded the condition in the Commission's approval of the NYNEX/Bell Atlantic merger that required the Company to continue its investment in Maine infrastructure for the four years following the merger at the same average rate as it achieved in the years 1992-1995. The Company was required, however, to continue to demonstrate through 1999 that the appropriate relationships exist between the services, facilities infrastructure and prices in Maine and in the remainder of the B/A jurisdictions.

D. Schools and Libraries Funding

The final area which we review is the funding mechanism for advanced telecommunications services for schools and libraries. While this matter is not strictly part of the AFOR, there is sufficient overlap to warrant mention here. The Commission required B/A-ME to spend up to \$4 million annually for five years for services for schools and libraries as part of Docket 94-254, which set the starting point for the Company's revenue requirement as it entered the AFOR. The original scope of the S&L program was modified several times during the course of the AFOR, but it now appears unlikely that the entire \$20 million balance will be spent by the time the AFOR expires. Therefore, the disposition of any excess funds must be decided. The current S & L program will end in 2001, and the structure of any new schools and libraries program will be determined in a separate proceeding, according to the provisions of 35-A M.R.S.A. § 7104-B

III ISSUES TO BE CONSIDERED

The following issues may be considered in reviewing the AFOR. We describe each issue briefly and set out the specific matters that we believe should be considered. This delineation is preliminary only and is intended as a starting point for discussion.

We seek comments concerning the issues and the specific areas that should be addressed. After we review the initial comments, we will more specifically set out the issues to be examined and the process to be followed in the proceeding. We are not requesting detailed comments about the substance of any of the issues. Rather, we are focusing in this stage of the proceeding on which issues deserve consideration.

A. Service Quality Index

We must decide whether the current SQI mechanism should be retained, revised or abandoned. If an SQI is retained, we must consider if the current indices are appropriate, or if they need revision, replacement or updating. For instance, are there more appropriate measurements of each item that can readily be included in the calculation? Are there important performance areas that the SQI is not measuring adequately or at all, such as network congestion? Should the indices be adjusted to include greater granularity in the measurements, as opposed to the statewide results that now characterize most of the measurements? Also, should we consider whether the SQI penalty and rebate mechanism are still valid, both from the standpoint of the calculation methodology and the size of the penalty? Finally, is it necessary to adjust and update the baselines?

B. Revenue Requirements

We must decide whether a revenue requirements examination is necessary, either to reset the pricing baseline if we continue or make minor modifications to the current AFOR, or to establish new rates if we were to discontinue the AFOR completely or adopt an AFOR that is significantly different from the current mechanism. One argument in favor of an alternative to rate of return regulation is that the link among rates, costs and earnings is broken. Assuming that is so, we seek comments about the need to examine the Company's level of earnings. Would the time and effort that will be necessary to conduct an earnings investigation be worth the result? Is it better to concentrate on regulating prices rather than earnings? Finally, should we consider some type of benchmarking process, either for prices or earnings?

Commenters on this issue should fully explain the reasons for their recommendations, particularly if the comments recommend that an earnings analysis be conducted. Parties who suggest that a rate case is necessary should state the priority that we should place on examining the Company's earnings compared with the other matters that must be considered in this proceeding. In preparing comments, commenters should consider the assessment criteria that we articulated in the order that initiated the AFOR, namely that universal service should increase, quality of service should be maintained or improved, prices should be lower, and new services should be available as market demand warrants. Are these criteria still valid and how important is each compared with the level of earnings attained by B/A-ME?

C. The PRI

We must determine if the PRI remains an appropriate mechanism for calculating the allowed rate of change in the Company's overall average price level, or whether there is a better way to establish the proper price cap. Alternatively, should the

Commission consider going to some type of “pure”, i.e. unweighted, capping mechanism that would apply only to a limited number of services? Further, even if the theory underlying the PRI is appropriate, is the mechanism working as intended? Is the GDPPI still the appropriate measure of inflation in the PRI formula? Is this index still an adequate reflection of B/A-ME’s input price changes, or if it is not, which inflation measure is more appropriate?

In our AFOR order, we explained that the most difficult evidentiary decision involved the productivity offset that is employed in the PRI formula. That may still be true today. Thus, we must examine the current 4.5% productivity factor to determine its continuing validity. We seek comments on the issues that should be considered in setting the offset factor, including whether an offset of any type is necessary or appropriate. Assuming an offset is valid, we also seek comments about the best method of determining the proper rate.

Finally, we will examine the definition of “exogenous changes” that can be included in the PRI calculation. Is it appropriate to include any exogenous factors in a price cap mechanism, and if any are included, how should those factors be determined and how should they be incorporated into the mechanism?

D. Designation of Services into Categories

It is appropriate to examine the types and categories of services that are included in the AFOR plan. Are the definitions of core and non-core services that we currently use adequate and appropriate? If not, how should they be changed? In light of the changing competitive and regulatory environment of the telecommunications industry, what are the proper designations for each of the services offered by the Company? Should there be more than two categories? Should we examine the process and structure of defining the service categories and assigning the individual services to the proper category? Should we explore the possibility that, because of the increasing use of digital technology, services are actually merging together, and thus, no differentiation by categories is appropriate?

E. Competition

We must also examine the relationship between competition and the establishment of an appropriate AFOR mechanism. Is there sufficient competition (service-by-service, or overall in the industry) to warrant moving some services out of regulation altogether? If so, how should we define and measure sufficient competition? Is there a quantitative basis for the decision, or must we rely on qualitative factors? What factors should be considered in deciding which services can be removed from regulation?

A central question is determining which services are covered by the AFOR. We seek comments on how we should judge if sufficient progress has been made with competition to allow relaxation of our regulatory mechanisms. If competition is found to be currently inadequate in some or all service categories or areas, should a periodic

review process be established that would allow us to revisit the subject on a regular basis?

F. Pricing Rules

We need to consider the appropriate pricing rules for the AFOR. Our decision in this matter depends to a certain extent on the decisions that we make concerning the services that are covered by the AFOR and the categorization of those services. What pricing rules are necessary and appropriate for each of the service categories that are established? How restrictive should those rules be? Should there be a mechanism to modify the rules during the term of the AFOR depending on the competitive environment of the industry?

G. Effects of the B/A-NYNEX Merger

In light of our assertions that we would examine the effects of the Bell Atlantic/NYNEX merger at the time of the AFOR review, we must now assess the benefits and harms that have resulted from the merger. Depending on our decision concerning the need to conduct an earnings investigation, we may have to analyze the actual level of cost savings that have resulted from the merger. After quantifying the savings, is it necessary to recognize some portion of those savings in the AFOR mechanism? Alternatively, if the level of savings is small or even nonexistent, is it appropriate to impute some level of savings into the AFOR? If we conduct an earnings investigation, an examination of merger benefits will occur as an inherent part of that proceeding. If a revenue requirements examination is not conducted, however, is it still proper to include some measure of the merger benefits (either actual or imputed) into the AFOR? Should this be accomplished through an explicit dollar adjustment or through an adjustment to the productivity offset?

A related concern is whether the merger has had anti-competitive effects. If it has, what should be done to compensate for those effects? How should this analysis be done? How conclusive are the results likely to be?

Finally, should we continue to be concerned about the level of the Company's investment in infrastructure and facilities in Maine and the types of services offered and prices charged compared to the other B/A jurisdictions? Is this type of benchmarking still appropriate in light of the evolving competitive nature of the industry? Should we require the Company to maintain a certain level of infrastructure and service offerings, or is it more appropriate to encourage competition to accomplish that purpose? What factors should be considered in this analysis?

H. Schools and Libraries

The first issue concerning the schools and libraries program is the disposition of any remaining funds at the conclusion of the program. Because it now appears that some portion of the \$20 million accrued by B/A-ME will not be spent, we invite comments on how the remaining amount should be used. Should it be returned to ratepayers as a credit or as some form of price reduction? Should it be used for infrastructure improvements or to promote universal service in some way? Should it be

incorporated into the Telecommunications Access Fund under 35-A M.R.S.A. § 7104-B?

Two related issues concern the \$4 million annual accrual that is put into the schools and libraries fund, and which will terminate on June 1, 2000. First, because the \$4 million annual amount was an adjustment to the revenue reduction found reasonable in Docket No. 94-254, B/A-ME must adjust its rates when the accrual ends. Also at the expiration of the accrual, there will be six months remaining in the current AFOR, so the Company must file a proposal for rate reductions in the amount of \$2 million over those final six months. In addition, the Commission must consider the issue of the \$4 million revenue requirement reduction in the future. If the Commission determines that a full revenue requirement analysis is appropriate, this issue will simply become a part of that examination. The Commission seeks comments on this matter.

IV. PROCESS

We will distribute this NOI to a wide group of potentially interested persons, and we ask that initial responses be provided in approximately six weeks, that is, by January 31, 2000. After we have reviewed the comments, we will issue a subsequent order that will describe specifically the issues that will be addressed in this proceeding. Following that, we will require the Company to make a filing with proposals that address the issues that we have identified. At that point, we may proceed on a litigation track with a time for data gathering, followed by hearings, an examiners' recommendation and a Commission decision. Alternatively, we may convene a collaborative process that would be facilitated either by our staff or by an outside facilitator. We seek comments on the type of process that will allow us to complete this case as expeditiously as possible, while providing the opportunity for full and meaningful participation by all interested parties.

Accordingly, we

O R D E R

That the Administrative Director should send a copy of the Notice to the following:

- 1) All parties in Docket No. 94-123 and 94-254;
- 2) All stakeholders in Docket No. 97-319; and
- 3) All parties in Docket No. 94-123 (reopened).

The Administrative Director will insure that duplicate notices are not sent to any person or party.

Dated at Augusta, Maine, this 27th day of December, 1999.

BY ORDER OF THE COMMISSION

Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR:

Welch
Nugent
Diamond

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.
2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Civil Procedure, Rule 73, et seq.
3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.